

May 16, 2001

LETTER 1318

WHAT LIES AHEAD: Ever since the Dow Theory bear signal of September 23, 1999 I've been maintaining that this was going to be an extended, tortuous, very difficult bear market.

I said that I thought this bear market could have many similarities with the long and costly bear market of 1966 to 1974. That bear market was made up of a series of mini-bull and mini-bear markets, the whole affair ending with the vicious collapse of 1972-74, the worst collapse, in fact, since World War II.

I have a number of reasons why I believe this will be an extended and very difficult bear market. Of course, it already has been terribly costly for those who have bought and held the tech stocks. But so far, the Dow itself has been down just short of 20% while the S&P has been down over 25%.

The first reason why I believe we are in for extended difficult times has to do with values, or I should say overvaluation in the market. The fact is, and I've emphasized this, that stocks are not priced to bring in good profits over the coming ten years.

Statistics and history tells us that. We know that when the price/earnings ratio on the S&P is as high as 22 the median annual return for stocks has been 5.0%. That statistic, however, was computed at a time when dividends were much higher than the current 1.2%.

There have been periods, over the years, when stock dividends contributed as much as half of annual total return for stocks. With dividend yields today at a lowly 1.2%, I doubt that over the coming ten years the median annual return on stocks will even be as high as 5.0%.

Then we have Robert Powers' study of cycles over the years. I'm going to include the Powers study again, and you can see that we are now entering the part of the cycle where the median annual total return has been zero. To put it another way, the profitable portion cycle is behind us. It's past.

April 27, DJIA 10810.01; PTI 5262; A-D Ratio -4.07

May 4, DJIA 10951.24; PTI 5278; A-D Ratio -3.57

May 11, DJIA 10821.33; PTI 5272; A-D Ratio -3.43

*Dow Times Book Value: +6.46

*Percentage of Undervalued Blue-chips: 8%

*Gold 34-day MA: 263.20 Dow yield: 1.62; Dow p/e: 22.7

Weak Cycles-----

1802-15	+2.7%	13 years
1835-43	-0.6%	08 years
1853-61	-3.0%	08 years
1881-97	+3.9%	16 years
1902-21	+0.0%	19 years
1929-49	+0.8%	20 years
1966-82	-1.4%	16 years

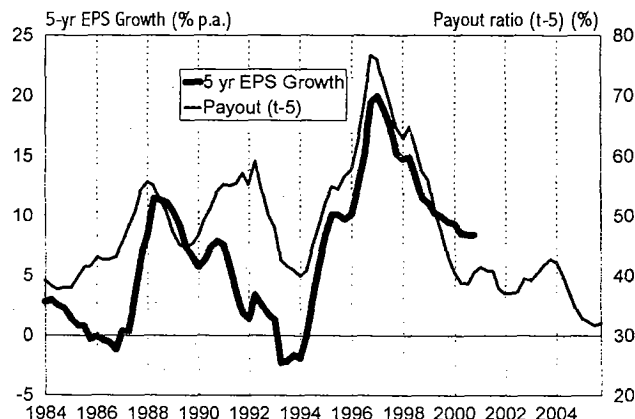
-Strong Cycles-----

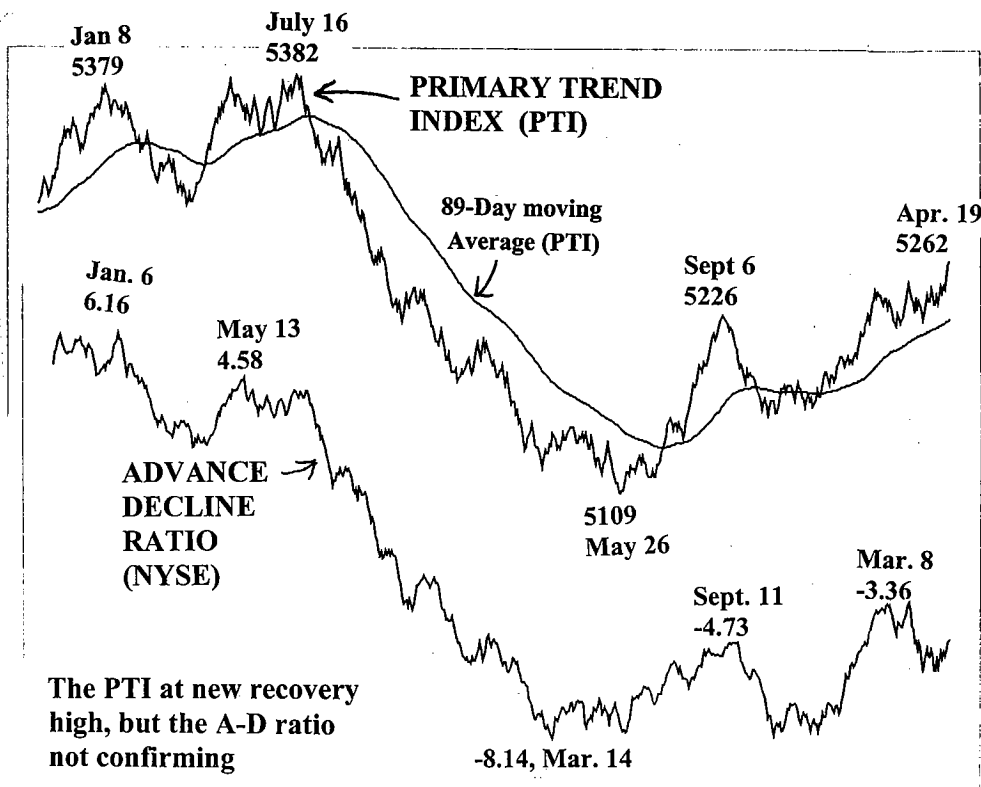
1815-35	+10.0%	20 years
1843-53	+13.7%	10 years
1861-81	+12.0%	20 years
1897-02	+15.2%	05 years
1921-29	+25.2%	08 years
1949-66	+14.0%	17 years
1982-99	+14.9%	17 years

A second fascinating study by economist and author Peter Bernstein (212 421 8385) shows that the trend of the dividend payout for stocks serves to forecast (when moved five years ahead) the percentage change in earnings per share for common stocks.

This chart from a recent Bernstein report shows the extraordinary correlation between the two. Here we see the payout ratio dropping to its recent low of 32%. This

% Change in EPS Over 5 Years & Payout Ratio 5 Years Earlier
Quarterly, 1984 - 2005





is the lowest payout of stock dividends in history. If the correlation holds, we can expect the percentage change in common stock earnings to continue to sink, dropping to a low about five years hence or into 2005.

Thus, the overall picture, as I see it, is a long, drawn-out but erratic bear market ending maybe years from now, and ending with stocks at "great values."

This does not mean that we won't see mini-bull and mini-bear markets, much as we saw in the 1966-74 period. These mini bull and bear markets might be set off by swings in the economy and swings in interest rates. The swings will also be set off by Federal Reserve action, as the Fed tries attempts to "jazz up" the economy via lower interest rates and rising money supply, and in turn tries to stem the forces of inflation via rising interest rates and a contraction in the money supply.

As an aside, I believe the Fed will ultimately be discredited; it will be seen as a destabilizing force and a force for simply exacerbating the market moves and the successive swings within the economy.

Another critical area will be the dollar. The US has possessed the incredible advantage of owning the world's reserve currency, the dollar. And, of course, the huge advantage that the US possesses is that it owns the

currency in which its own debts are denominated. Thus, if it wants to, the US can print its way out of debt simply by running the presses. No other nation possesses that advantage.

This strange phenomenon has allowed the US to take in the merchandise of other nations while paying them with fiat dollars that are simply manufactured "out of thin air." As a result, the US has been able to run negative trade balances of a billion dollars a week – and run these negative balances for years.

Question: How will the public react to this "long, exasperating" bear market that you forecast?

Answer: I believe the bear market will wear the public out. It will very slowly drive them out of the stock market. In time, the public will get tired of wrestling with the bear, and taking systematic losses. Before it's all over, the public will be as disgusted with stocks as they are now bullish about stocks.

Question: You keep talking about the "great values" that we will see in stocks when this bear market finally hits bottom. What do you mean by great values?

Answer: I'm sticking to the classic concept. I think stocks are great values when the blue chips sell for about ten times earnings while yielding around 6%.

Question: What do you think could drive stocks to the point where they become, as you put it, "great values?"

Answer: This becomes a guessing game. But I'll volunteer a few guesses. First, vicious global competition. Currently, we're seeing the rise of China and Asia as world-class competitors (if they're not there already).

Second: the economy remains sluggish – then, slowly but surely the stock market accords lower price-earnings to stocks. Investors decide to spend less and even save. The Fed proves helpless to turn the tide.

Third, the world gets tired of sending their goods to the US in return for dollars that can simply be manufactured by the Fed. The dollar swoons, setting off a frantic effort by foreign holders of US securities to turn in their securities and retrieve their own currencies.

Fourth, stagflation sets in with prices moving ever higher as the Fed's money-creating craze continues. In the face of this, bonds cave in and interest rates rise. The stock market tanks in the face of rising rates.

Fifth, Greenspan has a heart attack while playing tennis and is forced to retire. The stock market panics and fails to recover. The stock market loses its faith in the new Fed Chairman. Panic turns to pessimism and stocks remain in the doldrums.

GANN YEARLIES: There aren't many of us old-timers left who are fascinated with market trends. It seems that most of today's gurus and strategists are concerned with what stocks to buy and which stocks will beat the market.

There's nothing wrong with that, but if you want to invest correctly and not lose your shirt, I can tell you that it helps no end to buy in bull markets and to pretty much stay out of bear markets.

Jerry Favors is one analyst who does a great deal of work on the trends (614 840-0364). One of the techniques he uses was developed by the fabled W.D Gann, one of the great and fabled traders of yesteryear (look him up on the Internet).

Gann made use of both price action and time. He noted that when the Dow moved above the high of the previous year, this was a major plus, and such action turned his Gann yearly studies bullish. Conversely, when the Dow closed below the low of a preceding year, the Gann yearly chart

turned bearish. These Dow penetrations of previous year's highs or lows were one of Gann's most important trend devices.

For a number of years I've talked about the Dow's refusal to break below the low of a preceding year. But first, I want to recount a bit of history.

The 1981 high for the Dow was 1024.05. The 1981 Dow low was 824.01. The following year, 1982, saw the Dow head down. On June 18, 1982, the Dow broke below 824.01, the low of the preceding year. After that penetration, the Dow continued down to a closing low of 776.92 on August 12, 1982. **That was the last time that the Dow closed below the low of a preceding year.**

That mini-bear market ended with the Dow down 24.2% from its 1981 peak. It was a fairly mild bear market, but it did end in 1982 **with stocks at great values.**

Now let's turn to the present situation. Something has changed. Last year's Dow closing low was 9796.03. That low was violated on March 20 of this year. Two days later, on March 22, the Dow closed at 9389.48.

Thus, for the first time in 19 years we've seen the Dow close below the low of a preceding year. Following that break, we saw the Dow sink lower for only two additional days.

So the question – is that all there is? Having broken below a preceding year's low for the first time in 19 years, have we seen the bear market low?

With stock valuations now higher than at any previous bull market peak in history, is it logical or probable that we've already (on March 22) seen the low for this bear market? I have to doubt it. I have to believe that this market, one way or another, is going to go considerably lower.

We've already received a Dow Theory bear signal, we've now received a Gann Yearly bear signal, we've seen a collapse in the Nasdaq and a 25% decline in the S&P, but the Dow has halted just short of a 20% loss.

My belief is that regardless of intermediate action in the stock market, we will, in due time, see a major decline taking the Dow and the rest of the market below this year's low, as the bear market picks up "steam" on the downside.

At this point, one of the most difficult problems for the average investors has to do with patience. The market will not be hurried. In due time, if nothing else, we will see what is termed "a return to the mean."

The current market is currently far above the mean valuation of the last 75 years, but all history tells us that in time, the market will return to, or probably below, the long-term mean. Those who buy or hold stocks here face that silent risk – the inevitable “return of the mean.”

INVESTMENT POSITION:

Sorry, but the bear remains in the box. I just spoke to the general sales manager of one of the largest mutual fund outfits in the nation. He told me that it was discouraging that many of the funds in his company were only up 3% or 4% while the Dow had rallied to almost 11000.



With most mutual funds providing little or nothing in the way of dividend return and with the same funds showing only 4% appreciation, this is hardly a performance to gladden the hearts of fund-holders.

I asked this same manager (he's an old-timer) if he noticed anything unusual or outstanding in his travels around the country (he's constantly traveling). He said yes, what he found most unusual was “the continuing high level of optimism. People just remain incredibly bullish and hopeful regarding the stock market.”

I thought long and hard about this, and my conclusion is that 19 years of a generally rising market has generated bullishness that is not going to be erased quickly or easily. The “hold for the long term” syndrome has been drilled into the public's collective consciousness for so long that it will take years of dismal stock performance to erase that concept.

In my opinion, the security of choice in this market has been, and is, the T-bill or the Treasury note (ten years or less). For those who wanted to play this advance along the lines of the rising PTI, I've recommended the market proxies rather than picking individual stocks. The three proxies are the Diamonds, the Spyders, and the QQQ.

The March 22 closing low for the widely-traded Spyders (SPY on the Amex) was 111.12. Today SPY is at 126.50. Assuming you had bought SPY on the low day, you'd have about 15 points of paper profit, or about a 13.5% profit before taxes. Was this enough to justify the risk? I'll leave that to you. But believe me, even if you get in on a big bear market rally, it's not easy to come away with profits.

NOTES & QUOTES: The law is what the Supreme Court says it is. In 1895 the Supreme Court called the Federal income tax unconstitutional. They said it was unconstitutional because it was not apportioned to the states according to the Constitution.

Then in 1913 in the 16th Amendment to the Constitution, the income tax was made legal and a permanent addition to the tax system.

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The US has always needed an enemy, something or somebody on which we could center our anger and fear. My candidate for the next “enemy” is China. An article in the April 9 *International Herald Tribune* headlines it, “More Americans Call China ‘Unfriendly.’” As attitudes harden, some say a cold war mentality could return.”

China is a rising “capitalistic” nation with Communist rulers at its head. But the Chinese have always been good businessmen and tough traders. Furthermore, unlike the Russians, the Chinese are prodigious workers. Peruse through any store and check out the labels. “Made in China” is everywhere you look.

(Russell question: Have you ever seen a Chinese restaurant file for bankruptcy? I haven't.)

With globalization, China is becoming a huge exporter, and their labor costs are minuscule compared to US labor costs. China, I believe, will become a very tough competitor to the US, and we better get used to it. There's a world economic war brewing, and China will be an important part of it.

And this may be a guide to the future: a Washington Post/ABC News poll showed that by more than 2 to 1 Americans view China as an “unfriendly” country and a fifth view China as an “enemy.” Half interviewed said that China was “a military threat.”

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The following letter appeared in a recent issue of *Barron's*, and I thought it was worth re-reading. “I have a degree in finance, worked many years on Wall Street, and have closely followed the stock market for 53 years. I was always taught and firmly believe that the value of a company's stock is based on the balance sheet, profit-and-loss statement, cash flow, net worth, earnings, significant ratios, quality and depth of management, etc. For the past several years, all of the above seem to have been tossed out the window. Stock prices are now governed by analysts' predictions of earnings and outside factors that have nothing to do with a company's performance and proven history of profitable growth.

“When a company earns more this year than last, but falls short of analysts' ‘expert’ predictions, why does the market price of the stock decline? Do the analysts sell short? As long as the analysts are in control and basic values are set aside, the market will continue on its roller-coaster ride. The past couple of years have proven this without a doubt.”

Russell Comment: This fits right in with what I wrote above about risk and growth projections, and both have taken over from classic stock market analysis.

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I received a call a few weeks ago from an old friend and member of the NYSE. He talked about the declining trend of margin debt on the NYSE. He said that the brokerage houses, which charge high interest rates for margin accounts, are being hurt badly as the margin levels continue to drop. With stock transaction volume slowly receding and with margin levels also declining, the brokerage houses are in for rough times in this bear market.

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One of my favorite magazines is *American Heritage*. This is a magazine that always includes fascinating articles. Below is the jist of one from the latest issue.

Here's how Silicon Valley started. Two freshmen in 1938 tried out for the Stanford football team. One made it, the other didn't. But they became fast friends when, two years later, they discovered that they both loved hiking and they both shared an admiration for a Stanford electrical engineering professor named Fred Terman.

Terman saw great things ahead for Stanford, a young university that was situated far away from the center of technological innovation (i.e., the east).

The two friends graduated. One went to MIT to do graduate work; the other went to work for GE. Professor Terman, realizing that these two men were his best students, talked them into coming back to Stanford for advanced degrees. He also urged them to start an electronics company in the area. While climbing a mountain in Colorado, the two decided to "do it."

They rented a garage in Palo Alto and went into business with a total capital of \$538. Who were these two ambitious young men? One was William Hewlett; the other was David Packard. Hewlett later remembered, "We had a bowling-lane foul indicator. We had a thing that would make a urinal flush automatically as soon as a guy came in front of it. We had a shock machine to make people lose weight."

They also invented an audio oscillator for measuring sound waves, which Hewlett had developed as a student of Terman. The tiny company got its first break when Disney bought eight oscillators for \$71.50 a piece to use making the soundtrack of the movie, "Fantasia."

They baked their transformers in Mrs. Packard's oven. Packard ran the company while Hewlett served in the Signal Corp. Hewlett-Packard produced radio and sonar for the military. By 1950 the company was a leading national company for making scientific test and measuring devices.

Silicon Valley grew up around Stanford. A huge turning point came in 1956 when William Shockley, co-inventor of the transistor, returned to Palo Alto, his childhood home, to start the first semiconductor business there. Two years later Shockley's best engineers quit to form Fairchild Semiconductor. In the early '70s 41 other semiconductor companies were founded.

The company the two college buddies founded with \$538 had sales last year of \$60 billion (including its 2000 spinoff, Agilent Technologies). Hewlett and Packard spent most of their last years in philanthropy. In 1994 they contributed \$77.4 million to give Stanford a whole new science and engineering campus, and then they spent another \$25 million to endow a Frederic Terman Fellowship. It gives more than a dozen young scientists up to \$300,000 a year over three years. The funds are unrestricted.

Silicon Valley grew up around Stanford and Hewlett Packard. And in the meantime, Stanford (following Terman's dream) has become a great research university, and Silicon Valley has become world famous as the birthplace of "the new economy."

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Finally -- the NIH or National Institutes of Health is going to test the worth of chelation in a huge double-blind test. The NIH will be putting up \$30 million, \$6 million a year over five years, and they are asking for labs and doctors to participate in the study. Finally. Finally.

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What are values? There are many measurements, but one of the time-honored tests of values is the multiple that investors will pay for the S&P 500 Composite. Bull markets almost always start with stocks at "great values." The last two bull markets started with S&P price earnings as follows:

1974 the S&P was selling at 6.8 times earnings.

1982 the S&P was selling at 6.7 times earnings.

April 2001 -- the S&P was selling at 20.5 times earnings.

GOLD and the FED: If you're a gold-phile, thank "Easy Al" Greenspan, better known as "Mr. Inflation." In his frantic effort to avoid a recession, Greenie and the Fed (sounds like a rock band, doesn't it?) has opened the throttle wide, causing MZM to surge at a wild and crazy rate of 28% over a three-month period.

As I said, gold loves it. Throw an extra trillion dollars into the mix and it's got to stir up something. That something is housing, medical bills, restaurant prices, sports tickets, utility bills, and well -- most of the items you buy in your daily life.

Quoting from Caroline Baum's always excellent column on the Bloomberg site, "New York, May 7 - Last week the Shadow Open Market Committee, a self-appointed group of monetarists who keep tabs on the Federal Reserve, issued a scathing report on the Fed's recent activity.

"In short, the Committee said that the Fed 'has lost sight of its long-run objective of price stability,' and criticized the various and changeable explanations cited for its recent rate cuts, the latest being weak capital spending.

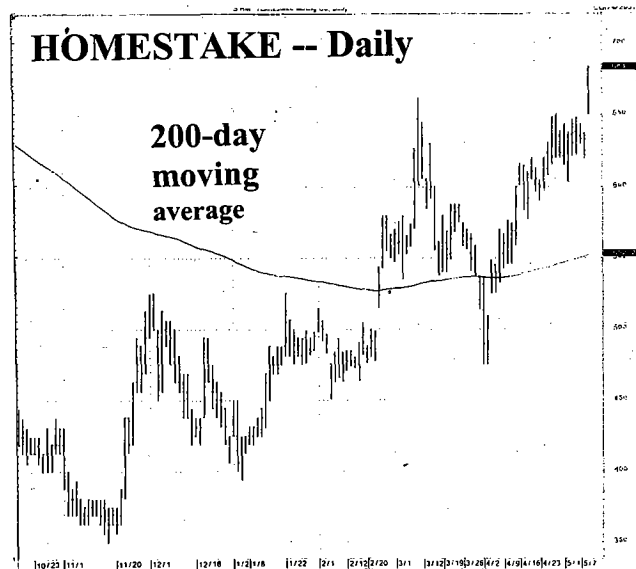
"Almost all measures of inflation are accelerating at a time when the Fed is stepping on the accelerator to stimulate demand.

"Rising inflation would be one thing if the raw material of inflation - money - was signaling disinflation ahead. Instead, April will be the fifth consecutive month to see double-digit annualized increases in the broad monetary aggregates, M2 and M3."

So the Fed, in its frantic effort to avoid recession, has opened the monetary spigots wide and dropped the rates a full 2 percent as well.

As I said, gold has received the message. Under Fed guidance, it's taking more paper dollars to buy anything and everything, and gold is no exception. Last week gold moved substantially above its 50-day moving average. Bellwether June gold rose above the 265 level to above 268 and appears to be heading for a test of its 200-day moving average at 274.

On Wednesday, May 9, the gold shares surged, with the leader, NEM (Newmont) moving above 20 and Homestake only 15 cents below 7. AEM (Agnico-Eagle) soared over 8, and PDG (Placer Dome) was two cents under 11. These are big percentage moves.



A few months ago I urged subscribers to buy HM (it was 3 1/2 at the time), and NEM when it was in the 12-14 range. If you bought 'em, hold 'em. Alan Greenspan is on your side.

LATE NOTES: All the Wall Street analysts and strategists seem to agree that March 22 was the long-lost "BOTTOM," and that now is the time to load up with stocks again (assuming you sold out somewhere along the line).

"We've seen the capitulation, stocks are cheaper with many on the bargain table, and the Fed has turned the stock market into a virtual bargain bazaar. Buy, buy, buy."

Could they be right? Yeah, they could but I continue to be highly skeptical. I hate to bring up the subject of valuations, but if March 22 was a market bottom, it was a bottom that offered the highest valuations of any bottom in history.

I mean, this was a bottom with the S&P 500 selling at 23 times earnings when proven bottoms such as 1974 and 1982 saw price/earnings on the S&P at 6.8, not 23.

But this is the New Economy, and maybe in the New Economy bear market bottoms will offer valuations that resemble the "old" bull market tops. But wait, in the New Economy maybe you don't need a return on your investment and risk doesn't matter --which explains why here in the New Economy the yield on the S&P is only 1.25%. After all, who needs a return on one's investment when stocks "over the long run" will always be higher?

I still have about 1300 subscribers who don't own computers or internet equipment and will have nothing to do with them. Are they missing anything? Of course they are. But these "hold-outs" are also missing the hair-pulling frustration of dealing with computers and computer software. Computers can crash, they can act erratic, they can die, they can burn out. They can drive you up the wall. Maybe the whole thing is best illustrated by the cartoon below.

NEXT MAILING: June 6, 2001

